

# THE LENDER OF LAST RESORT<sup>1</sup>

*In the light of the recommendation made by the recent Banking Sector Consultancy Study, this speech clarifies and elaborates on the HKMA's policy and practice as lender of last resort. Details of the policy statement are set out on pages 77-82.*

## The HKAB and HKMA Partnership

I am delighted to have this opportunity to speak to the Hong Kong Association of Banks (HKAB) at its half-yearly dinner again. The last opportunity for doing so was in December 1992 when, ahead of the formation of the Hong Kong Monetary Authority (HKMA), I spoke as the Chief Executive (Designate) of the HKMA. It has been almost seven years, and although it is rare for the HKAB to invite the same speaker a second time, I must confess that I was privately beginning to wonder. Then your current Chairman picked up the phone with this very timely invitation that I gladly accepted. This is perhaps yet another good indication of the close partnership and understanding built up over the years between HKAB and HKMA. Together we have been through a lot and have achieved a lot. Our work together has embraced the continuous process of monetary reform; the strengthening of our supervisory framework; the building of a sophisticated financial infrastructure, notably the establishment of CMU and the introduction of RTGS; the preparation for the Handover; and the handling of the Asian financial turmoil or, to give it perhaps a more appropriate term, the crisis of globalisation. And we emerged from all this with the most robust banking system in the region. Indeed, the HKAB and HKMA partnership is a very important one, as we continue, in accordance with the requirement laid down in the Basic Law, to develop Hong Kong as an international financial centre.

And there are many more challenges ahead for us that require an even stronger partnership to

handle. We are all well aware of the forces of globalisation and technological advance, and the opportunities and risks associated with them. The Asian financial turmoil has also put us on clear notice that those forces, made more potent by the activities of the highly leveraged institutions, can be brutal and do not tolerate excesses or mistakes. It takes great effort, particularly in a small and entirely open international financial centre, for both the regulated and the regulator to harness these forces, and derive and maximise the benefits that undoubtedly flow from them. This process is likely to involve changes to both the structure of the banking sector and to the supervisory framework, perhaps to the extent of affecting special interest groups. But the fact of the matter is that changes are inevitable. And in coping with them, we have a choice between either dealing with the relevant issues ahead of time, making full use of our strong partnership, or leaving them to the brute forces of the market. I must say that I have a preference for the former, even at the risk of inviting further accusations that the HKMA is being interventionist, for I am concerned about the possible disruptions and systemic risks of the latter. But I can assure you that the HKMA has never been, and never will be, in the habit of handing down directives to the banking sector, or of requiring commercial banks to take any actions that go against their own commercial interests. The strong partnership between HKAB and the HKMA is built upon dialogue and realism, on the ability of both sides to appreciate the issues at hand, and on a determination to tackle them in a co-operative spirit without any political fanfare. Long may this strong partnership continue.

<sup>1</sup> This is the text of the speech delivered by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Hong Kong Association of Banks Half-Yearly Dinner on 29 June 1999.



## The Banking Sector Consultancy Study

Indeed, working closely together, we are now as well prepared as we can be for the next challenge - the arrival of the new Millennium. In our preparations for the challenges of the new century we have benefited from the co-operation of HKAB in the Banking Sector Consultancy Study. As you are aware, the Consultancy Study was commissioned last year with the aim, among other things, of assessing the regulatory and supervisory changes necessary to enable Hong Kong's banking sector to address the challenges and opportunities of the coming five years. It is a strategic attempt to enable the banking system to manage the forces of globalisation and technological advance in a way that will make banks more efficient, more innovative and more competitive.

The thrust of the recommendations in the Consultancy Study is greater competitiveness through liberalisation, deregulation and simplification. But an equally important message is that greater competitiveness should not be achieved at the expense of the safety and soundness of the banking system. The challenge is how best to exploit future opportunities while containing the risks. Recognising that the global trends it has identified are likely to increase the level of risk to which banks are exposed, the Study makes a number of recommendations designed to enhance the safety and stability of the system as a whole. You are aware of the details of the recommendations. You may also wish to be aware of the fact that the internal deliberation within Government, after the three-month public consultation period earlier this year, is drawing to a close, and an announcement on the Government's decision on the recommendations will likely be made shortly. I would like to take this opportunity to thank HKAB again for the very helpful views expressed on them. I would also like to take this opportunity to deal specifically with one of the recommendations that has been widely supported in the comments received during the consultation period, although the subject matter itself may involve a certain degree of controversy both in theory and practice. This is the recommendation that the HKMA should clarify its role as lender of last resort.

## HKMA as Lender of Last Resort

It might be worth pointing out first that some clarification of this issue was, in fact, provided in a luncheon speech I gave to the American Chamber of Commerce as long ago as October 1994. The speech was subsequently published in our Quarterly Bulletin of November 1994 under the somewhat bland title 'Stability of the Banking System in Hong Kong'. It is not a good practice to quote from one's own speeches, particularly those that are nearly five years old, but I could not resist plucking out two sentences from about half way through that speech, in which I state that:

'there is an official lender of last resort in Hong Kong and that this is the HKMA. Some persons, even within the banking community in Hong Kong, still seem to be not quite clear about this.'

A long explanation of the concept and functions of the lender of last resort as applied to Hong Kong followed this remark. Despite the explanation, it seems that there remains some confusion about the policy. The Report on the Consultancy Study finds that 'there is still a substantial level of uncertainty' about this issue and 'a large number of participants in the sector who are either unaware that there is actually a lender of last resort or are unclear as to the conditions under which the HKMA would provide this assistance'. This has not been helped by erroneous suggestions in some prominent newspapers that the replacement of the Liquidity Adjustment Facility with a Discount Window, as one of the seven technical measures introduced last September, has effectively ended the HKMA's role as lender of last resort. The issue has been further clouded by the equally erroneous academic argument that the role as lender of last resort should not be mixed with the HKMA's role as operator of a Currency Board system.

The Consultants offer a number of other reasons why there should continue to be such uncertainty: the strongest, perhaps, is the fact that, since our establishment in 1993, the HKMA has never had to exercise its function as lender of last



resort. I think we would all hope that this will long continue to be the case. And so, in the absence of an actual demonstration of the lender of last resort policy in action, we have to continue to rely on explanations of the principles behind the policy. With this in mind, I shall shortly be sending copies of a detailed policy statement on the HKMA's role as lender of last resort to the chief executives of all authorised institutions in Hong Kong, and we shall be giving extensive publicity to the policy statement. I shall give here both a summary of, and an elaboration on, that policy statement.

### The Need for Clarification

Further clarification is particularly necessary at this time, notwithstanding the point that the general principles outlined in my 1994 statement still apply. The banking environment has changed quite dramatically in the past five years. Last year, after many years of growth, Hong Kong, in common with much of the rest of the region, entered a period of sharp recession, with all the stresses and uncertainties that this has brought to the banking sector. The face of banking across the world has also developed rapidly in the last five years. There are strong justifications for the HKMA not only to restate the principles under which we are ready to provide liquidity support to institutions experiencing difficulties, but also to further clarify the objectives, the mechanics, and the limits of this support.

As I have said, it has so far not been necessary for the HKMA to exercise its role as lender of last resort, though we have, on one or two occasions, said that we stand ready to do so. Given the volatility that has been generated by the Asian financial crisis and the serious problems that have been faced by banks elsewhere in the region, this is in itself a remarkable testament to the resilience and prudence of our banking sector. It also underlines the effectiveness of our regulatory and supervisory system, which, as any good system should, takes a preventive rather than a curative approach. During the more extreme periods of the Asian crisis, however, one of the main concerns of market participants was the high level of uncertainty in the market about whether and to what extent

lender of last resort support would be forthcoming should it be required. In fact, the liquidity shortages experienced during the more volatile periods may have been in part attributable to this market uncertainty. Arguably, this uncertainty may also have aggravated the credit crunch during the crisis periods. The introduction of the Discount Window in September 1998 has helped to ease this problem. A greater knowledge and awareness of the availability of a lender of last resort facility will, we hope, further help to reduce uncertainty, and will, in turn help to improve overall market liquidity in the event of future crises, should they arise. A formalised policy framework will also help the HKMA itself to ensure speed and consistency in considering whether or not to extend lender of last resort support. A quick response in an uncertain environment could be of vital importance in helping to restore stability and confidence to the banking system.

But it must be acknowledged that there are also good arguments for not saying too much on the subject. The HKAB, while expressing general support for clarification, has rightly observed that the HKMA must be able to maintain sufficient flexibility to be able to handle widely differing situations, to deal with abrupt changes, and to take action in a timely way. There is a further argument for maintaining a degree of constructive ambiguity in order to avoid encouraging moral hazard by setting out too clearly the terms on which support might be forthcoming. This is a valid point. But it is also worth noting that the problem of moral hazard, while it can never be entirely eradicated, has been considerably reduced in Hong Kong in recent years. A sound and well established regulatory and supervisory framework has increasingly limited risk-taking activities, and the trend is towards risk-based rather than institution-based supervision. A high level of market transparency allows market discipline mechanisms to work effectively, and risk control systems at the institutional level are generally adequate. In fact, given the degree of sophistication and stability that Hong Kong's banking environment has achieved, spelling out the rules clearly would, in my view, have positive advantages. Clear criteria on collateral requirements in the event of lender of



last resort support, for example, may well provide incentives for institutions to hold better quality assets and thus further reduce moral hazard.

### **The Scope of Lender of Last Resort Support**

But it is necessary to be clear about what is meant by lender of last resort support. So let me now deal with this important definitional point. Lender of last resort is a term which tends to be used rather loosely, and may mean different things to different people. There are in fact three activities of a central bank which might be referred to as lender of last resort. Two of these do not concern me today. They are, first, the provision of intra-day liquidity under the RTGS system and overnight liquidity through the Discount Window, the main objective of which is to ensure the smooth functioning of the interbank payment system on a day-to-day, short-term basis; and, secondly, and at the other extreme, longer-term liquidity support or capital support to a probably insolvent bank, the failure of which would have wider implications for the stability of the monetary and financial systems of Hong Kong.

The role of lender of last resort which I am addressing today is neither of those, but comes somewhere between the two. It involves the provision of support to banks that are basically solvent but are troubled by short-term funding difficulties. The immediate purpose of such support is to provide some breathing space to allow the institution to implement corrective measures. The overall aims would be, first, to prevent illiquidity in that particular institution from precipitating a situation of insolvency and, secondly, to prevent the contagion to other banks and hence a crisis for the system as a whole.

### **The Legal Framework**

This crucial consideration, the effect on the system as a whole, brings me to the question of the resources available to the HKMA, and the legal and other limitations placed on the HKMA, in the exercise of its role as lender of last support. These resources are to be found in the Exchange Fund, the use of which, as you know, is governed by the Exchange Fund Ordinance. Under this

Ordinance, the uses to which the Fund may be put are quite specific. Section 3(1) of the Ordinance states that the Fund ‘shall be used primarily for such purposes as the Financial Secretary thinks fit affecting, either directly or indirectly the exchange value of the currency of Hong Kong and for other purposes incidental thereto’. Section 3(1A) further provides that ‘the Financial Secretary may, with a view to maintaining Hong Kong as an international financial centre, use the Fund as he thinks fit to maintain the stability and integrity of the monetary and financial systems of Hong Kong’. Under section 5B of the Ordinance, the Financial Secretary has delegated day-to-day decisions on the use of the Exchange Fund under these sections to the Monetary Authority.

The clear indication here is that the use of the Exchange Fund must be for systemic purposes. The guiding principle in considering whether to provide lender of last resort support to an individual authorised institution is therefore whether the failure of that institution, either by itself or through spreading contagion to other institutions, would damage the stability of the exchange rate or the monetary and financial systems. It is neither possible nor necessary to give an exhaustive list of all the instances that might be covered by this principle. Contagion might, for example, arise where other institutions are heavily exposed to the troubled institutions or share characteristics that could be interpreted as the origin of its problems. General sentiment could also be a factor; when, for example, there is heightened nervousness about the stability of the banking or monetary systems. But there are many other possible scenarios.

### **Consistency with Currency Board Arrangements**

A limitation on the HKMA's exercise of lender of last resort support is the need for consistency with the Currency Board arrangements in Hong Kong. Our Currency Board system requires that the monetary base, which in effect represents the ultimate liquidity of the financial system, can only expand along with increases in foreign reserves - or, more precisely, with the foreign reserves in the backing portfolio, which has been established to segregate the Currency Board



component of the foreign reserves. However, the system would not preclude use of the Exchange Fund's other assets, including its Hong Kong dollar assets, outside of the Currency Board account, to provide last resort support to a problem institution. Nor would it preclude funding temporary liquidity injections through borrowing from the interbank market or through a sale of foreign currency assets held by the Exchange Fund, again outside of the Currency Board account, not touching those assets earmarked for the Backing Portfolio. A further option would be for the HKMA to operate within the Currency Board account and conduct repos using Exchange Fund paper or US dollar assets. None of these mechanisms would breach the Currency Board rules, since the Hong Kong dollar liquidity thus created, in the form of the addition to the Aggregate Balance of the banking system, would be matched either by a decline in another component of the monetary base (the Exchange Fund paper) or an increase in US dollar assets.

Beyond this, we have stated on several occasions in the past that, in exceptional circumstances, where there is a risk that large-scale Hong Kong dollar transactions might create extreme conditions in the interbank market and affect the stability of the exchange rate - to an extent unwarranted by any economic fundamentals - the HKMA may temporarily lend or borrow Hong Kong dollars to or from the interbank market to dampen these extreme conditions. Should an imminent bank failure pose the threat of triggering extreme conditions in the money and foreign exchange markets, there may be justifications for the HKMA to inject liquidity directly into the interbank market, on a temporary basis, to ensure systemic stability. This would represent a departure from the strict rules of the Currency Board system. The availability of excess foreign currency reserves allows some scope for discretion, but the intention would anyway be that this injection should be only temporary.

### **Preconditions for Lender of Last Resort Support**

The basic precondition for lender of last resort support is the systemic risk that would, in the judgement of the HKMA, arise from the failure of a troubled institution if it were deprived of

liquidity assistance. This is the basic precondition, but not the only precondition. The institution in question would also need to satisfy a number of further conditions designed to demonstrate that lender of last resort support is genuinely being sought as a last resort, and that such support would not amount to throwing good money after bad. To be specific, the additional preconditions are:

First, the institution would need to have a sufficient margin of solvency. As a measure of sufficiency, we would generally require the institution to demonstrate that it maintains a capital adequacy ratio of at least 6% after making adjustment for any additional provisions that might be necessary.

Secondly, the liquidity support extended to the institution would need to be adequately collateralised.

Thirdly, the institution should have sought other reasonably available sources of funding before seeking lender of last resort assistance.

Fourthly, the shareholder controllers of the institution should have made all reasonable efforts to provide liquidity or capital support as a demonstration of their own commitment to the institution.

Fifthly, there must be no prima facie evidence that the management is not fit and proper, or that the liquidity problem is due to fraud.

And sixthly, the institution must be prepared to take appropriate remedial action to deal with its liquidity problems.

The policy applies to locally incorporated institutions whose failure might have systemic implications, and not to branches of foreign banks operating in Hong Kong, since the liquidity of a branch cannot readily be divorced from that of the bank as a whole. The expectation is that, in the event of difficulties, the head office of the branch, supported if necessary by the lender of last resort in the home country, would provide enough funding to enable the branch to meet its obligations. There are, however, two circumstances in which the



HKMA might provide financial assistance to a branch of a foreign bank with funding problems. The first would be for the HKMA to swap Hong Kong dollars for US dollars held by the branch if no suitable counterparty could be found in the market. The second would be to provide urgently required bridging finance on a secured basis to a branch pending receipt by it of funds from head office.

### **Instruments for Lender of Last Resort Support**

The policy statement that will shortly be issued to banks contains extensive details about the instruments that the HKMA would use for lender of last resort assistance. Since the supply of Exchange Fund debt, even at about HK\$100 billion, is limited, and there is a lack of other Government debt, the range of collateral against which lender of last resort support would be provided must necessarily be wider than in some other economies. There are three basic instruments that the HKMA would use to provide support: purchase of the institution's placements with other banks; repos of eligible Hong Kong dollar securities; and a credit facility against the security of the institution's residential mortgage portfolio. The details are set out in the policy statement and its annexes, and I do not intend to go into them here, but I do wish to highlight three points. First, given that the purpose of liquidity support is to provide a temporary breathing space to allow the institution to sort its problems out, any support provided through repos or through a credit facility would be provided for an initial term of no more than 30 days, although there would be a provision for it to be rolled over for a further 30 days. Secondly, the interest rate charged on lender of last resort support would be pitched at a level sufficient to maintain incentives for good management but not at a level so high as to defeat the purpose of the facility, which is to prevent illiquidity from precipitating insolvency. Thirdly, notwithstanding the availability of suitable collateral, there will be a maximum limit on the amount of support provided to an individual institution through repos or the credit facility. This limit would normally be set at between 100% and 200% of the capital base of the institution concerned subject to a cap of HK\$10 billion.

### **Exceptions**

We believe that the provision of these details will go a long way towards removing market uncertainty and improving market liquidity, especially in times of crisis. This is the first time that we have made clear our requirements and parameters in setting out the mechanics for lender of last resort support. The emphasis, both in these details and in the preconditions for support, is on a rule-based approach more than on discretion or constructive ambiguity, and this is consistent with the HKMA's policy of transparency.

It is, however, necessary to stress that the policy still requires the exercise of discretion by the HKMA at various stages - in judging whether a systemic risk exists, for example, in deciding whether an institution meets the preconditions for support, and in determining the methods and level of support. Furthermore, any policy that is essentially a contingency plan for dealing with unusual, unanticipated, and undesirable situations must necessarily contain a provision for circumstances that fall outside the framework outlined in the policy. Such a situation might arise where, for example, an institution is unable to comply with the preconditions for lender of last resort support that I have outlined. Or it may require a longer breathing space or a larger amount of support than that prescribed in the limits I have set out. Or it may propose other forms of security than the three that have been specified. Support in such cases would be considered in the light of the implications of failure on systemic stability and would not be granted without the specific prior approval of the Financial Secretary. In addition, the Monetary Authority would consider whether to appoint a Manager under Section 52 of the Banking Ordinance to safeguard the interests of depositors and other creditors. The aim in providing for cases that fall outside the conditions set out in the policy statement is to allow sufficient flexibility for the HKMA to deal with unpredictable situations, a point that has been well made by the HKAB, but also to ensure that this flexibility is matched by adequate checks and balances.



## Conclusion

Before offering my concluding remarks on the policy of lender of last resort, I should like to make some observations on the institutional position of the HKMA as lender of last resort. When I addressed this subject in 1994 I pointed out that the establishment of the HKMA, and the placing of both monetary and banking supervision functions under one roof, had given a much more precise institutional focus to the lender of last resort function, and that the amendments to the Exchange Fund Ordinance in 1992 had further helped to clarify the scope of that function. I should like to reiterate that point this evening, more especially in the context of the world-wide debate about the merits of a super-regulator system, under which supervisory functions would be institutionally separate from central bank functions. Quite apart from the question, which still remains to be answered, of whether monolithic super-regulators really provide the efficient, economic, streamlined system they set out to achieve, there are, in my view, strong arguments, in the interests of efficient crisis management, for having the banking regulator as close as possible to the lender of last resort. From this point of view, I share the doubts expressed in the latest BIS Annual Report about 'whether central banks stripped of supervisory responsibilities will be able to obtain the information they require, when they need it, to use their emergency liquidity support powers wisely and effectively in a market-driven world.'

One of the arguments of those who would like to see the institutions of regulator and lender of last resort clearly separate is that too close a relationship may give rise to serious conflicts of interest which could prove costly to the public purse in terms of over-generous support operations. However, the arrangements which I have described here ensure that there is no use of public funds, except those which are fully collateralised, at least until referral to the Financial Secretary has been triggered.

To conclude, I should like to repeat the simple statement that I made in 1994: that there is an official lender of last resort in Hong Kong, and that this is the HKMA. My speech this evening, and the policy statement soon to be circulated, will,

I hope, help put a speedy end to the doubts and uncertainties about this point and about whether our role as lender of last resort is consistent with our role as operator of a Currency Board system. The detailed policy statement has also set out, more clearly and precisely than ever before, the circumstances in which lender of last resort support will be extended, the preconditions for obtaining support, and the mechanics for arranging it. The lender of last resort function - the ultimate source of liquidity in a banking system - is one of the most important functions of any central bank. One of the measures of the soundness of a banking system, however, is the rarity with which this function is exercised. The fact that the HKMA has not yet had to activate its lender of last resort policy is perhaps one of the firmest demonstrations of the soundness and stability of Hong Kong's banking system that we could have. We owe this success to the prudent policies and skilful management pursued by the members of this Association and to the productive partnership between regulated and regulator - between HKAB and the HKMA. This is a strong and healthy basis from which to tackle the challenges that now face us, and I look forward to seeing that partnership continue to flourish in the years ahead. ☘